Report on Operations Under the European Bank for Reconstruction and Development Agreement Act

2006

CANADA'S NEW GOVERNMENT

Canada

Report on Operations Under the European Bank for Reconstruction and Development Agreement Act

2006

Department of Finance Canada | Ministère des Finances Canada

Available from the

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Also available on the Internet at
www.fin.gc.ca

Cette publication est également disponible en français.

Cat. No.: F1-29/2006E
ISBN 978-0-662-45365-9

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A Word From the Minister of Finance

I am pleased to present to Members of Parliament and to the Canadian public the Department of Finance's 2006 *Report on Operations Under the European Bank for Reconstruction and Development Agreement Act*. This report responds to the requirement laid out in Article 7 of the European Bank for Reconstruction and Development Agreement Act that the Minister of Finance "shall cause to be laid before each House of Parliament by March 31 of each year or, if that House is not then sitting, on any of the thirty days next thereafter that it is sitting," a report containing a general summary of operations under this act, including their sustainable development and human rights aspects.

The format of this report differs significantly from those of past years. Given feedback from parliamentarians and civil society on this report and its companion report (*Report on Operations Under the Bretton Woods and Related Agreements Act*), this report has been recast with three goals in mind:

1. To improve the accountability of the Department of Finance in managing Canada's relationship with the European Bank for Reconstruction and Development (EBRD).
2. To make Canada's policy objectives with respect to this institution clearer, which in turn will make it easier to measure success.
3. To have Canada continue to push the frontiers of disclosure, without violating Canada's requirement to respect the confidentiality policies of the EBRD.

The 2006 report focuses more clearly on Canada's policy objectives at the EBRD, which can be summarized as:

1. Promoting good governance and accountability, including respect for human rights.
2. Promoting the environmental sustainability of EBRD projects.
3. Ensuring that the EBRD shifts its operations to where transition is less advanced.
4. Advancing Canadian commercial interests.

It is my hope that this report will provide parliamentarians and all Canadians with a better understanding of the role that Canada is playing in promoting governance and accountability in the institution and in ensuring that the EBRD's operations accord with its transition mandate.

The Honourable James M. Flaherty, P.C., M.P.
Minister of Finance

A Word From the Minister of Finance

I am pleased to present to Members of Parliament and to the Canadian public the Department of Finance's 2005 *Report on Operations Under the European Bank for Reconstruction and Development Agreement Act*. This report responds to the requirement set out in section 7 of the *European Bank for Reconstruction and Development Agreement Act* that the Minister of Finance "shall cause to be laid before each House of Parliament [illegible] or, if that House is not then sitting, on any of the first [illegible] days next thereafter that it is sitting," a report containing a general summary of operations under the Act, including their environmental, developmental and human rights aspects.

The format of this report differs significantly from those of past years. The formatting, with performance and risk scoring on the report and its commitment to [illegible] and reporting, [illegible]. Under the section *Views and Related Agreements*, the report is [illegible] goals in mind:

1. To improve the accountability of the Department of Finance in managing Canada's relationship with the European Bank for Reconstruction and Development (EBRD).

2. To make Canada's priorities known with respect to the institution's operations and its relationship with other stakeholders.

3. To have Canada continue to play the leadership role that Canada [illegible] require it to respect the [illegible] policies of the EBRD.

The 2005 report focuses more directly on Canada's policy objectives at the EBRD, which can be summarized as:

1. Promoting good governance and accountability, including support for human rights.

2. Promoting the environmental sustainability of EBRD projects.

3. Ensuring that the EBRD delivers operations to meet its mandate in the region.

4. Advancing Canadian commercial interests.

It is my hope that this report will provide parliamentarians and all Canadians with a better understanding of the role that Canada is playing in advancing good governance and accountability within the institution and in ensuring that the EBRD's operations remain consistent with its mandate.

The Honourable James M. Flaherty, P.C., M.P.
Minister of Finance

Mandate and Role of the EBRD

Overview

The European Bank for Reconstruction and Development (referred to in this document as the EBRD or the Bank) was established in 1991. Its aims are to foster the transition towards open, market-oriented economies in Central and Southeastern Europe, as well as in the successor states of the former Soviet Union,[1] and to promote private and entrepreneurial initiative in those countries that are committed to the fundamental principles of multi-party democracy, pluralism and market economics.[2] To deliver on its mandate, the Bank focuses its activities on assisting its 29 countries of operations in implementing economic reforms, taking into account the particular needs of countries at different stages in the transition process. The EBRD also places particular emphasis on the promotion of democratic institutions and human rights in its countries of operations.

The Bank's overriding focus is the private sector, with a strong operational emphasis on enterprise restructuring, including the strengthening of financial institutions, and the development of infrastructure needed to support the private sector. The EBRD's charter stipulates that not less than 60 per cent of its financing commitments should be directed either to private sector enterprises or to state-owned enterprises implementing a program to achieve private ownership and control. All of its financing projects have to demonstrate environmental sustainability as per the Bank's Articles of Agreement. In promoting economic transition, the Bank acts as a catalyst for increased flows of financing to the private sector, as the capital requirements of these countries cannot be fully met by official multilateral or bilateral sources of financing, and many foreign private investors remain hesitant to invest in the region, particularly the central Asian republics. For example, in 2006, for every euro the EBRD invested, it mobilized an additional 1.7 euros from the private sector and other multilateral and bilateral agencies.

The EBRD's operations to advance the transition to a market economy are guided by four principles: transition impact, additionality, sound banking and environmental sustainability. Financing is provided for projects that expand and improve markets, help to build the institutions necessary for underpinning a market economy, and demonstrate and promote market-oriented skills and sound business practices. EBRD financing must also mobilize additional sources of financing and not displace them. Bank projects must be sound from a banking perspective, thus demonstrating to private investors that the region offers attractive returns. Adherence to sound banking principles also helps to ensure the financial viability of the EBRD and hence its attractiveness as a co-investment partner for the private sector. Finally, the Bank assesses the environmental sustainability of all of its projects, and its project environmental safeguards are leading-edge.

The Bank's medium-term operational priorities are premised on: the central importance of creating and strengthening institutions that ensure markets work well; the key role that small businesses can play in creating dynamic, competitive and more equitable economies; and the relevance to the transition process of the Bank's mandate to support countries committed to and applying the principles of multi-party democracy and pluralism.

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1 In 2006, all members formally accepted Mongolia as one of the Bank's countries of operations.

2 Article 1, Agreement establishing the European Bank for Reconstruction and Development.

To achieve these priorities the Bank focuses on:

- Promoting transparency and accountability in public sector management.
- Developing sound financial sectors linked to the needs of enterprises and households.
- Providing leadership for the development of micro-lending and small and medium-sized enterprises (SMEs).
- Developing market-based and commercially oriented infrastructure.
- Demonstrating, through selected examples, effective approaches to restructuring viable large enterprises.
- Taking an active approach in its equity investments to improve corporate governance.
- Engaging governments in policy dialogue to strengthen institutions and improve the investment climate.
- Taking a regional approach where appropriate.
- Promoting sustainable development and environmental due diligence.

Countries of Operations

The EBRD has 63 members: 61 countries, the European Community and the European Investment Bank.

Chart 1

EBRD Membership

Note: Canada's 3.4-per-cent share in the EBRD translates to an equivalent percentage of votes in the organization.

How the EBRD Works

The highest authority in the Bank is the Board of Governors. It meets annually and approves the institution's annual report, budget, financial statements and independent auditor's report, the election of the Chair and Vice Chair for the next Annual Meeting, as well as other items requiring Governors' approval. A Governor and an Alternate Governor represent each member country. The Board of Directors, which is responsible for the general operations of the Bank, is composed of 23 members, of which four are non-Europeans.

The EBRD's share capital is provided by member countries, with proportional voting rights. The EBRD's authorized capital is €20 billion—Canada's capital share is 3.4 per cent.

Project Finance

The EBRD offers a full array of financial products and services, including:

- Longer-term loans.
- Equity investments.
- Quasi-equity instruments (subordinated loans, preferred stock, income notes).
- Guarantees and standby financing.
- Risk management (intermediation of currency and interest rate swaps, provision of hedging facilities).

Eligibility

Eligible projects must be supported by a strong business case, benefit the economy of the host country and comply with the EBRD's environmental guidelines. Projects in all industries are eligible for EBRD financing except those producing military equipment, tobacco and distilled alcohol. Although it primarily finances private sector projects, the Bank may provide financing to state-owned companies provided they are operating competitively, particularly if the financing attracts private and/or foreign capital. The EBRD may finance both locally and foreign-owned private companies, as well as joint ventures between foreign and local shareholders.

In order to ensure the participation of private sector investors and lenders, the EBRD limits the total amount of debt and equity financing for any single project to 25 per cent of total estimated project costs. However, in certain circumstances, it may provide up to 35 per cent of the equity capital for a project, provided it is never the largest shareholder.

EBRD investments range from €5 million to €230 million. Smaller projects are financed both directly by the EBRD and through local financial intermediaries. By supporting local commercial banks, micro-finance banks, equity funds and leasing facilities, the EBRD has helped finance over 1 million smaller projects.

Fees

The EBRD charges market rates for its private sector financing and provides uniform loan pricing for sovereigns of LIBOR (London Inter-Bank Offered Rate) +100 basis points. In addition, fees vary according to the nature of the project and the amount and complexity of the work required of the EBRD.

Funding of EBRD Activities

The EBRD's equity and quasi-equity investments are funded out of its net worth—the total of paid-in capital and retained earnings. Of the funding required for its lending operations, 100 per cent is borrowed in international financial markets through public bond issues or private placements. The EBRD's bond issues have been given triple-A ratings by Moody's Investors Service and Standard & Poor's.

Advice and Technical Assistance

The Bank uses its close relationship with governments in the region of operations to promote policies that bolster the business environment. The EBRD advises governments on how to promote a sound investment climate and a stronger institutional framework, which helps to ensure a well-functioning private sector. The EBRD provides advisory services in the following areas: effective legal and regulatory framework, business integrity and sound corporate governance, anti-corruption practices, fair and predictable taxation, and transparent accounting.

Canada's Representation at the EBRD: The Honourable James M. Flaherty, Minister of Finance, is the Canadian Governor and Mr. Peter Harder, Deputy Minister of Foreign Affairs, is the Alternate Governor. Canada's representative on the EBRD Board of Directors is André Juneau. The Minister (Economic/Commercial) at the Canadian High Commission in London, Ms. Judith St. George, is the non-resident Alternate Director and represents Canada in the absence of the Canadian Director.

Canada's EBRD Priorities

Canadian Policy Priorities

Canada's participation in the EBRD supports our international development and foreign policy priorities. Canada is committed to sustainable development that promotes democracy, peace and security, human rights and equality and contributes to a more secure, equitable and prosperous world. By fostering transition towards open, market-oriented economies in its countries of operations, the Bank advances Canada's international priorities, strategic interests and values. Through sound investments that support economic growth and contribute to the transition region's integration into the world economy, the EBRD promotes prosperity and stability, which are important to Canada as a trading nation.

The Government of Canada has four priorities in relations with the EBRD:

1. Promoting good governance and accountability (at the national and corporate level), including respect for human rights.
2. Promoting the environmental sustainability of EBRD projects.
3. Ensuring that the EBRD maintains a strong transition focus and shifts its operations to countries where transition is less advanced.
4. Advancing Canadian commercial interests.

1. Governance and Accountability

Canada's involvement with the EBRD provides the opportunity to promote the Canadian values of democracy, rule of law, accountability and respect for human rights. Canada is a strong proponent of the Bank's ongoing efforts to improve and strengthen governance and accountability in its countries of operations (through technical assistance programs and dialogue with national and local authorities) so as to ensure increased transparency, optimal use of investment funds, promotion of the rule of law, respect for human rights, safety and equality. Canada also supports the Bank's efforts to encourage mechanisms of multilateral cooperation on democratic issues.

Improved Corporate Governance

Canada has maintained that the Bank's fundamental priority for private sector development is to create an enabling environment for investment and sound regulatory frameworks for the private sector to develop in a sustainable fashion. Good governance helps ensure that corporations integrate into the international financial system and strengthens their international competitiveness. Strong, transparent governing institutions improve their effectiveness and accountability towards their people. To this end, through technical cooperation funds, the EBRD advises national and local governments on ways to improve and strengthen their institutional frameworks in order to ensure a well-functioning private sector.

Strong Internal Governance

Canada is pleased with the Bank's commitment to enhance the transparency of its activities, in line with modern corporate governance practices. This focus is consistent with efforts at other international financial institutions (IFIs), which Canada has also strongly supported.

Canada welcomes the Bank's efforts to benchmark its practices against those of other IFIs. The EBRD has developed and implemented a series of policies and strategies—most notably Codes of Conduct and an Anti-Corruption Strategy—to ensure that it follows best practices. These are described in detail in the section "Canada's Focus in 2006."

Strong Democratic Institutions

In keeping with its mandate to promote economic and democratic reform, the Bank regularly reviews political and economic progress in transition in its countries of operations. The EBRD has limited its operations in Belarus, Turkmenistan and Uzbekistan, where the commitment to core democratic principles is particularly weak. The country strategies for Belarus and Turkmenistan were renewed in 2006 and, given the lack of progress in economic and political reform in both countries, the Bank's approach of severely restricting its operations was reconfirmed. As the geographical focus of the Bank's operations continues to shift to more challenging environments, the EBRD's commitment to the political requirements of Article 1 remains imperative. EBRD analysis shows a strong, positive relationship between progress in transition and political liberalism, i.e. the establishment of strong, democratic institutions.

2. Environmental Sustainability

Environmental and social issues are increasingly regarded as fundamentally connected with long-term sustainability of economic performance, political stability and the quality of life of a region's inhabitants. Canada has an interest in promoting environmental sustainability in the transition region as a means of fostering a strong global economy. Canada is therefore a strong proponent of sustainable best practices with respect to EBRD investments in both the public and private sector. EBRD priorities include:

- Fully integrating environmental and social (e.g. health and safety, labour and community issues) considerations into the project cycle and ensuring that each project considered for financing undergoes environmental and social appraisal.
- Promoting environmental investments across a variety of sectors to achieve resource efficiency, cleaner production processes, biodiversity and best practice in environmental management.
- Financing projects with clear environmental objectives, such as better water and wastewater management, energy efficiency and renewable energy, and working in partnership with other institutions to address regional and global environmental issues.[3]

3. Transition Impact

Canada has a strong interest in ensuring that nascent democratic regimes have access to the financing and advice they need in order to deliver on their political and economic efforts towards transition to market-oriented democracies. The EBRD has an important role to play in this process. The entry of eight EBRD borrowers into the European Union in May 2004 marked a milestone in the transition process and its success. The EBRD played no small part in this process, helping these countries create the right conditions to attract private sector financing without the Bank's participation. Going forward, the Bank must shift its operations to borrowing countries in the former Soviet Union and Southeastern Europe that have the greatest need for the EBRD's support.

[3] *EBRD Sustainability Report 2005: Working Towards a Sustainable Future.*

4. Advancing Canadian Commercial Interests

The EBRD offers a number of investment opportunities for Canadian businesses, including financial institutions. The objectives of the Canadian office are to increase Canadian awareness of these investment opportunities, explain how the Bank's financing mechanisms work, and ensure that EBRD policies and procedures are followed in a transparent and fair manner.

To achieve these objectives, the Canadian office provides EBRD market information and intelligence to Canadian firms and advises Canadian project sponsors on EBRD financing options. In addition, the office develops commercial co-financing opportunities with Export Development Canada and other Canadian financial institutions. Together with the Department of Foreign Affairs and International Trade and Industry Canada, the office also identifies EBRD procurement opportunities and, with the Canadian International Development Agency (CIDA), promotes Canadian technical cooperation activities and official co-financing with the EBRD.

In 2006, the Board of Directors approved two investments with Canadian involvement. The first involved a loan to support the modernization and expansion of Chelopech Mining EAD, a Bulgarian company which is fully owned by Dundee Precious Metals Inc. of Toronto. The second was a multi-vendor leasing framework in Russia, which was jointly developed by Export Development Canada and the EBRD.

In 2006, 14 contracts totalling €4.6 million were awarded to Canadian consultants for project preparation, project implementation and investment climate reform support. The assignments were funded by CIDA technical cooperation funds at the EBRD (eight assignments), by the EBRD directly (four assignments), and through other untied technical cooperation funds at the EBRD (two assignments).

Canada's Voting Record in 2006

On January 30, 2004, the Minister of Finance, as Governor for Canada at the EBRD, voted to amend the Agreement establishing the European Bank for Reconstruction and Development to authorize the Bank to undertake operations in Mongolia. This proposal had the unanimous support of EBRD members, given Mongolia's close economic linkages to the former Soviet bloc countries and its long history with central planning. Canada ratified the amendment to the EBRD's Articles of Agreement in the Budget Implementation Act, 2006.

On June 3, 2006, after declaring its independence from the State Union of Serbia and Montenegro and being recognized as an independent country by the international community and the Government of Serbia, the Republic of Montenegro was formally admitted as a member of the EBRD. In September 2006, following a Governors' vote, which Canada supported, the Republic of Montenegro became a borrowing member of the EBRD.

On November 6, 2006, Governors voted to adjust the formula for calculating the remuneration of Directors, Alternate Directors and the President of the EBRD. Canada supported proposed changes.

Canada's Voting Record

Canada and other shareholders typically raise concerns and questions about specific Bank operations before they get to the Board of Directors. As a result, decisions at the Board are generally taken by consensus. Directors may, however, abstain or vote against projects or policies in consultation with their constituencies. Canada supported all policies in 2006 as well as the vast majority of the 300 projects approved. There were 13 exceptions for three main reasons.

- **Lack of additionality.** Additionality is one of the EBRD's core operating principles—project investments should support private investors without crowding them out. If it is possible that an investor could have access to private sector funding on reasonable terms, additionality concerns are raised. Canada abstained from voting on or voted against three projects on these grounds.

  1. An EBRD investment in the Royalton Partners II regional equity fund. This fund will make controlled or equity-related investments in middle-market private and privatized companies in Central Europe. The fund will focus on non-tradable sectors and will seek opportunities to increase value by improving operations and/or expanding businesses. Canada voted against the project.
  2. An EBRD loan to a Russian bank (MDM Bank) to support its lending operations. Canada abstained from voting on the project due to additionality concerns.
  3. An EBRD loan to a Russian subsidiary of LG to help finance a new consumer electronics and white goods production facility near Moscow. Canada abstained from voting on the project due to additionality concerns, also referencing its marginal transition impact.

- **Lack of transition impact.** Helping to move a country closer to a full market economy (the "transition impact") is another of the EBRD's core operating principles. As per Article 2 of the Agreement establishing the European Bank for Reconstruction and Development, transition is fostered through various measures including: promoting the establishment, improvement and expansion of productive, competitive and private sector activity and the mobilization of capital and experienced management to this end; fostering productive investment, including in the service and financial sectors, and in related infrastructure where necessary to support private and entrepreneurial initiative; providing technical assistance; and supporting multinational projects and/or projects with more than one donor country. Where it is anticipated that an investment will not achieve an incremental transition impact on these terms, concerns are raised. Canada abstained from voting on or voted against five projects on these grounds.

  4. A seventh extension of the EU/EBRD SME Finance Facility to partner banks for on-lending to micro and small enterprises (MSEs) in the EU accession countries (Bulgaria, Romania and Croatia). While it supports the Facility's objectives, Canada abstained from voting on the extension due to the use of EU-funded interest rate subsidies.
  5. A loan to VTB Retail Financial Services for on-lending to MSEs in Russia. Canada voted against the project, also referencing questionable use of a state-owned bank as a financial intermediary.
  6. An equity investment in the Russian bank Ogresbank. Following the entrance of a strong, strategic investor, the project's transitional impact became less clear. Canada abstained from voting on the investment, also referencing additionality concerns.
  7. A loan to Sukhoi Civil Aircraft Company to help finance the development and manufacturing of a regional jet in Russia. Canada voted against the project, also referencing concerns about significant state aid and additionality.
  8. A loan to help finance the design, construction and start-up costs of a super-regional mall (Kashirka Mall) in southeast Moscow. Canada abstained from voting on the project.

Canada's Voting Record *(cont'd)*

- **Discord with Canada's policy on steel**. Canada does not support steel projects at multilateral development banks that contribute to excess global capacity given that there is already global oversupply. Canada abstained from voting on or voted against five projects on these grounds:

  9. A loan to Mittal's Ukraine subsidiary (Mittal Steel Kriviy Rih) to optimize current capacity and improve energy efficiency. Mittal acquired the subsidiary in November 2005 in a transparent, market-priced re-privatization of the company. Despite the proposed operational and environmental improvements, Canada voted against the project, also citing additionality concerns.
  10. A loan to help restructure a steel mill in Romania (S.C. Donasid) to enable it to increase production. Canada abstained from voting on the project.
  11. A co-generation project in Ukraine (Ekoenergia) to help increase steel production. Canada abstained from voting on the project.
  12. A modernization project in Russia for the ChTPZ Group. Canada abstained from voting on the project.
  13. A loan to ISTIL Ukraine to support the company's financial restructuring and growth. Canada abstained from voting on the project.

Canada's Focus in 2006

1. Improved governance and accountability.
2. Reinforcement of Article 1 of the Agreement establishing the European Bank for Reconstruction and Development.
3. Reassessment of the EBRD's mission and a new operational framework.
4. Promotion of a sound investment climate through strong institutions.
5. Environmental sustainability.

1. Governance and Accountability

A key element underpinning the Bank's ability to influence transition is the demonstration effect of its own governance policies. The EBRD, therefore, must set for itself the very highest standard of internal governance. Canada supported the Bank's efforts to ensure that its internal policies continue to conform to best practices.

Codes of Conduct

Canada supported the introduction of new Codes of Conduct for EBRD officials and the EBRD Board of Directors. The new codes were introduced following a review in 2004 which recognized the need to update the Bank's original Code of Conduct.

The new Codes of Conduct, approved by Governors at the 2006 Annual Meeting, have been aligned with the existing best practices of other international financial institutions (IFIs). They also provide guidance on avoiding and handling conflicts of interests; establish a transparent mechanism for

examining requests for derogations; regulate the manner in which private financial affairs can be conducted and the level of disclosure required; and provide for a robust procedure for dealing with alleged breaches of the codes.

Public Information Policy

Canada was active in encouraging the Bank to enhance the transparency of its activities, in line with modern corporate governance practices. This focus is consistent with efforts at other IFIs, which Canada has also strongly supported.

Canada welcomed the Bank's decision to broaden its public disclosure policy. In 2006, the Bank agreed (a) to disclose minutes of Board of Directors' meetings; (b) to make more information on its internal organization available on its website (including the Bank's organigram, as well as the terms of reference and membership of committees of the Board of Directors); (c) to make project summary documents available in relevant national languages; (d) to provide a summary of the annual staff compensation and benefits proposal; and (e) to post a list of policies and strategies scheduled for development or review in the year ahead.

Anti-Corruption Strategy

Canada was also active in pressing the Bank to strengthen its anti-corruption policy. Canada supported the Bank's proposal to amend its practices and fight corruption in line with the harmonized approach developed by the main IFIs. Canada commended the Bank's effort to move quickly with the adaptation of the new harmonized definitions and subsequent amendments to its existing procurement policies and rules, so that they conform with the common strategic approach developed by main IFIs.

Canada is looking forward to the first report on results, in particular to seeing how well the new anti-corruption and fraud prevention guidelines have been balanced with the Bank's objective to support the development of the private sector.

Canada commended the Bank for publishing its first anti-corruption report,[4] aimed at informing shareholders, other financial institutions and investors about the EBRD's efforts to combat corruption and fraud in its own operations. The report also includes highlights of studies dealing with the prevalence of corruption in the EBRD's countries of operations.

2. Commitment to Article 1—Engagement in Belarus

Canada took a strong stand in favour of a vigorous interpretation of the Bank's responsibilities under Article 1 of the Agreement establishing the European Bank for Reconstruction and Development to severely restrict operations in countries where the commitment to democratic values is very weak. The EBRD has an explicit political mandate, as set out in Article 1, to foster transition in countries that are committed to and applying the principles of multi-party democracy and pluralism. In countries with poor democratic and human rights records such as Belarus, the Bank limits its scope of activities to the financing of the private sector while continuing to seek ways of improving the investment climate and supporting reform efforts.

4 Available at www.ebrd.com/about/integrity/report.pdf.

The new EBRD Strategy for Belarus, approved in 2006, reflects the fact that the country's progress towards implementing Article 1 continues to be slow and characterized by setbacks. The development of the new strategy had a high profile in Canada, given the Canadian government's firm position on the need for democratic reform in Belarus. In practical terms, at IFIs, Canada has consistently opposed EBRD lending to the Belarus government, while holding open the possibility of supporting small EBRD operations with private sector entities that address basic human needs. The EBRD's new strategy for Belarus, which continues to focus exclusively on the private sector, is consistent with this approach.

3. Reassessing the Bank's Mission and Operations

Canada played an active role in the development and discussion of the EBRD's third Capital Resources Review (CRR3), stressing the need for the institution to move decisively to increase its operations in the early transition economies of the former Soviet Union and Southeastern Europe. At the EBRD's 2006 annual meeting, Governors approved the CRR3, which outlines new strategic directions that define the Bank's transition objectives, operational activities, risk management, financial performance and resource requirements. A key feature of this strategy is the graduation, by 2010, of the eight Central European countries that joined the EU in 2004. The strategy will commence with the consolidation and closure of three resident offices in Central Europe in 2007, complemented by an expanded presence in other countries, including Russia and Ukraine.

Canada welcomed the CRR3 and supported the EBRD's shift in operations to Southeastern Europe and the former Soviet Union, where more significant transition challenges remain. This strategic framework will ensure that the EBRD's resources are allocated to where they can yield the greatest transition impact.

4. Promotion of a Sound Investment Climate

A Well-Functioning Financial Sector

Canada strongly supports the EBRD's activities in the financial sector as vital to integrating transition countries into the global economy. The EBRD seeks to strengthen confidence in the financial sector primarily by helping to improve local institutions' governance and business practices. It also tries to improve financial supervision and regulation, although its activities here are constrained by its investor role in the sector and potential concerns about conflict of interest. Nonetheless, as a reputable foreign investor in the sector, the Bank offers important insights on supervisory and regulatory requirements, which it shares with other IFIs operating in the region and with governments. To address competition and independence, EBRD investments attempt to increase the diversity of institutions and services available, particularly to the private sector and micro, small and medium-sized enterprises, to facilitate foreign direct investment and to strengthen the commercial orientation of state-owned financial institutions, particularly in preparation for privatization.

The Bank also contributes to a well-functioning financial sector through its efforts to stimulate the development of local capital markets. One approach involves the EBRD working with authorities to help develop the legal framework for the issuing of local currency bonds. The EBRD's three domestic ruble floating-rate note issues (one in 2005 and two 2006) highlight both the transition potential of developing local capital markets and the extensive regulatory dialogue required.

In preparing these issues, the Bank has worked closely with the Russian authorities since 1999 and has provided technical and legal expertise to develop the framework for the issuance of long-term local currency bonds. The bonds represent an important step in the development of the Russian capital market, as they introduce a new asset class to Russia and open the door to other international issuers. The EBRD is working with other governments, including in Ukraine and Kazakhstan, with the same objective in mind.

Micro, Small and Medium-Sized Enterprises

Canada supports the Bank's strategy to promote micro, small and medium-sized enterprise (MSME) growth, develop proper financial instruments for MSME support and encourage the development of strong business associations. Canada is a strong proponent of fostering the development of local management expertise, skills and innovation. It is a strong supporter of the Bank's strategy for the MSME sector, which is founded on three pillars: financing, improving the investment climate through policy dialogue and developing business support networks for MSMEs. The strategy explicitly recognizes that the poor investment climate, and not just limited access to financing, is a major impediment to the development of the sector.

Fostering the development of strong private sectors in its countries of operations is an essential element of the EBRD's strategy for promoting the transition to a market economy. A strong MSME sector is the backbone of a country's sustained economic growth and is crucial to help countries become internationally competitive and self-sufficient. A dynamic local workforce undertaking a full spectrum of business activities, coupled with well-established local financing arrangements, ensures that countries are less vulnerable to global capital movements.

5. Environmental Sustainability

Sustainable Energy Initiative

Canada welcomes an expanded role for the EBRD on the issues of climate change and increased energy security. Canada has already contributed some funds to the Sustainable Energy Initiative through its €20-million commitment to the "nuclear window" of the Northern Dimension Environmental Partnership Support Fund.

As one of the fastest-growing parts of the world, the transition region has a growing demand for energy. One of the major challenges facing the region is inefficient use of energy, a legacy of the former command economy that undermines the competitiveness of enterprises and economies, threatens energy security and contributes disproportionately to carbon emissions.

The EBRD presented its Sustainable Energy Initiative at the 2006 Annual Meeting, and the initiative was broadly supported by the Bank's shareholders. Under the new initiative, the Bank would more than double its energy efficiency and cleaner energy investments over the next three years by mainstreaming sustainable energy investments across all sectors, strengthening the Bank's capacity to deliver; ramping up its policy dialogue in cooperation with other international institutions; and establishing a new partnership with donors to support the initiative.[5]

[5] EBRD, *Sustainable Energy Initiative: Furthering Transition, Securing the Future—Summary Document*, July 2006.

Canada's Participation in the EBRD

Benefits of Participation

Canada's membership in the EBRD and its active participation in the discussion of policy and operational issues enable it to project Canadian values and to help shape regional norms and rules. By supporting continued political and economic reform in Central and Southeastern Europe and the former Soviet Union, Canada is contributing to the region's stability and integration into the world economy.

Canada and the Bank share the overriding objective of developing a strong private sector in the Bank's countries of operations by mobilizing financing for projects with a high transition impact and by providing advice and technical assistance to businesses and governments. Through its participation in the EBRD's Board of Directors' policy discussions, Canada has been able to reinforce this mandate and press for greater attention to governance issues in the Bank's operations. Moreover, Canada has been able to help shape environmental and social safeguard policies that govern EBRD lending. The EBRD also provides Canada with a vehicle through which it can reach poor transition countries that are not normally reached through our bilateral development assistance programs.

As detailed earlier, Canada is also interested in securing important commercial benefits. In order to implement transition projects, the Bank often relies on goods and services from its members through procurements. This allows Canadian firms to have access to different markets and to enjoy commercial opportunities they may not otherwise have. An area where Canada has a comparative advantage and where Canadians have been successful in winning EBRD-financed contracts is consulting services. In 2006, however, interest by Canadian companies in bidding on EBRD-financed public tenders was weak, and no Canadian firm was awarded a tender. However, the EBRD offers Canadian companies considerable opportunities to finance investments in its countries of operations as well as access to public sector tenders.

Looking forward, the EBRD hopes to increase the number of high-quality Canadian project sponsors with which it invests to better align its official co-financing and technical cooperation needs with Canadian interests in the region, and to strengthen its partnership with Export Development Canada and other Canadian commercial co-financiers.

Governmental and Professional Involvement

Role of Canadian Government Departments—Within the Canadian government, responsibility for oversight of the EBRD's activities resides with the International Policy and Institutions Division of the Department of Finance. In consultation with the Department of Foreign Affairs and International Trade and the Canadian International Development Agency (CIDA), the Department of Finance regularly reviews the Bank's policy papers and proposed country strategies and provides advice to the Canadian Director.

Functions of the Canadian Director—In addition to participating in regular Board meetings, the Canadian Director is currently a member of the Board of Directors' Budget and Administrative Affairs Committee, which monitors efficiency, cost control and budgetary prudence, oversees the Bank's human resources policies (including those relating to governance and ethics), and ensures that the Bank's resources are directed towards its priorities.

Canadian Staff at the EBRD—Canadians are well represented on EBRD staff. At the end of 2006, there were 23 Canadian professionals on the staff of the EBRD, representing 3.4 per cent of total professional positions, equal to Canada's 3.4-per-cent share of the institution's capital. It is noteworthy that Canadians fill the following positions: Director of Communications, Director of the Procurement Department and Director of the Early Transition Countries Initiative. Members of the Canadian Director's office made a number of visits to Canada and the EBRD's countries of operations in 2006 to meet with business people, conduct seminars, speak at conferences and consult with government officials.

The following events in 2006 were supported by the Canadian Director's office and promoted Canada's interests:

- The Canadian Director and Business Advisor participated in the Canada Trade Days in Kiev, Ukraine, which was sponsored by the Canadian Embassy in Kiev.
- The Canadian Director went to Moscow to participate in the Adam Smith Conference and meet with Canadian and Russian business and government officials.
- On the Canadian outreach side, the Canadian Director and the Business Advisor organized the visit of EBRD President Jean Lemierre to the Conférence de Montréal and arranged a business program, including additional meetings with Canadian corporates interested in investing in the Bank's region of operations
- The Business Advisor and an EBRD Russia team senior banker participated in the Canada Eurasia Russia Business Association (CERBA) Canada-Russia forestry business seminar. The Advisor also participated in the Globe Environmental Industries Effective Bidding Workshop in Vancouver to identify opportunities for Canadian companies in environment-related procurement at the EBRD, as well as the annual CIDA/CME (Canadian Manufacturers & Exporters) International Development Days (IDD) held in Winnipeg. The Canadian office arranged for the EBRD Director of the Consulting Services Unit to participate in the CIDA/CME IDD, as well as business outreach programs with the Ontario and Alberta governments and industry association representatives in Toronto and Calgary.
- The EBRD's Deputy Chief Economist and Director, Strategy and Analysis and the Canadian Policy Advisor travelled to Toronto and Ottawa to present to business, academics and government officials key findings of the Bank's 2006 *Transition Report* on developments in the business and economic environments of the Bank's countries of operations.

Contribution to Ordinary Capital Resources

At the end of 2006, the total authorized capital of the Bank was €20 billion. Canada's share is 3.4 per cent, or €680 million (C$968 million), of which 25.3 per cent, or C$245.2 million, is paid-in. The remainder is callable and would be provided only in the unlikely event that the EBRD faces severe financial difficulty. Canada's paid-in contribution is treated as a non-budgetary expenditure as shares in the Bank are considered an asset. Our callable capital represents a contingent liability.

Canada's paid-in capital is being provided in a series of instalments of cash and non-interest-bearing demand notes, which are then encashed over a five-year period. Payments are made in eight equal annual instalments (40 per cent in cash and 60 per cent in non-interest-bearing demand notes). Canada's last note encashment will be made in 2009.

Canadian Payments to the EBRD

Year	Total cash payments in US$ (includes note encashment and cash payments)	Total cash payments in C$[1] (includes note encashment and cash payments)
1991	23,807,004	27,278,065
1992	15,871,336	19,177,335
1993	19,839,170	25,588,561
1994	23,807,004	32,517,987
1995	23,807,004	32,677,494
1996	7,935,668	10,821,077
1997	3,967,334	5,492,325
1998	6,315,572	9,366,645
1999	7,773,010	11,549,451
2000	9,230,449	13,709,085
2001	10,687,891	16,549,305
2002	12,145,331	19,072,539
2003	12,145,331	17,021,217
2004	12,145,331	15,807,394
2005	12,145,331	14,715,677
2006	5,829,759	6,611,492
2007	4,372,320	4,958,620[2]
2008	2,914,880	3,305,747[2]
2009	1,457,440	1,652,873[2]

Notes: 1 Exchange rates are based on Bank of Canada annual noon exchange rate averages.
2 2006 exchange rate used as an estimate.

EBRD Transactions in Canada or in Canadian Currency

The EBRD did not undertake any transactions in Canada in 2006.

Contribution to Special Funds

In addition to its financing activities through loans and equity investments, the EBRD advises businesses on a variety of issues, including: physical and financial restructuring; the formulation of business plans; identification of markets, products, technologies, and financial and technical partners; and mobilization of project finance. These advisory services are provided through special funds set up in partnership with donor countries and/or donor institutions. As the Bank continues to shift its operations towards the south and the east of the transition region, these funds and the technical capacity-building assistance they offer will grow in importance. Canada has contributed to the following special funds:

Early Transition Countries Multi-Donor Fund—CIDA is one of the 11 donors to this multi-donor fund, which was launched in 2004 and targets Bank programming in the seven poorest countries of the EBRD's region of operations (Armenia, Azerbaijan, Georgia, the Kyrgyz Republic, Moldova, Tajikistan and Uzbekistan). This fund is the first EBRD funding mechanism to be classified as Official Development Assistance by the Development Assistance Committee of the Organisation for Economic Co-operation and Development (OECD/DAC). Canada has contributed C$1.7 million to this untied fund.

Canadian Technical Cooperation Fund—The main purpose of this fund is to provide financing to hire Canadian consultants for EBRD projects across a wide range of sectors and EBRD countries of operations. Canada has transferred C$17 million to the EBRD for technical cooperation since 1992. Canada's contribution, which was renewed in 2006 for an additional three years until 2009, includes technical cooperation in Armenia, Georgia, Russia and Ukraine, and focuses on the environment, private sector development and municipal governance.

Chernobyl Shelter Fund—The main purpose of this fund is to secure the sarcophagus around the destroyed Unit IV nuclear reactor in Ukraine. The total estimated cost of this 10-year project is roughly US$1.1 billion, of which US$716 million has been pledged so far. Canada has pledged US$33 million, including US$0.8 million of bilateral assistance for ventilation stack repair.

Nuclear Safety Account (NSA)—This facility was established in 1993 to help finance the closure of the Chernobyl nuclear power plant and to improve safety conditions at nuclear power plants in countries of operations until the plants can be closed. The NSA complements other bilateral and multilateral nuclear safety technical assistance and functions in parallel with multilateral efforts to achieve broader energy sector reform in the region. Canada has contributed C$19.5 million to the total fund of €280 million. Canada's contribution has been completely disbursed.

CIDA-EBRD Cooperation Fund for Southeastern Europe (CFSEE)—By 2002, Canada had contributed $10 million in support of the EBRD's South Eastern Europe Action Plan, to be used for technical cooperation and co-financing activities. These funds, tied to Canadian consultants, were used in Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Romania, Serbia and Montenegro. In 2003, an additional $6 million was added to the CFSEE to support work on CIDA priority sectors and countries of focus. CIDA is participating, through the CFSEE, in a newly created Western Balkans Initiative, which includes within its scope a multi-donor technical cooperation fund and is intended to improve donor coordination arrangements in the Western Balkans.

TurnAround Management Programme—The TurnAround Management Programme was established in 1993 to match senior industrial advisors from market-driven economies with chief executives of selected firms in the region that are in financial difficulty. The objective is to provide industrial management know-how and develop business skills so that these companies can become competitive and profitable. Canada has contributed C$2.55 million to this fund.

Technical Assistance in Support of the Ukraine Micro, Small and Medium-Sized Enterprises Line of Credit II—Canada agreed to provide C$3 million for technical assistance services by qualified Canadian organizations to Ukrainian commercial banks receiving loans under the EBRD's Ukraine Micro, Small and Medium-Sized Enterprises Line of Credit II for on-lending to micro, small and medium-sized enterprises. To date, C$2.12 million has been transferred to the Bank for technical assistance that includes risk- and loan-evaluation training. The Fund is now being used in support of the Mortgage Lending Framework, focusing on local banks' capacity building.

Northern Dimension Environmental Partnership—Canada is the sole non-European contributor to this fund, which provides donor funding to address severe environmental problems in northwest Russia, particularly in the areas of nuclear waste, water and wastewater treatment, and energy efficiency. Canada has committed €20 million, which is earmarked for the facility's "nuclear window" and counts towards Canada's commitment to the G8 Global Partnership Program.

CIDA-EBRD Cooperation Fund for Central Asia and the South Caucasus—This C$2-million fund was created in 2004 for work on project preparation and implementation activities in Central Asia and the South Caucasus. The fund targets the following sectors: agribusiness, natural resources, infrastructure financing (e.g. transport, telecommunications, municipal finance), and capacity development of local institutions working in private sector development and micro-lending institutions. Given CIDA's program focus, priority will be given to projects in Georgia and Tajikistan. This is the first Canadian bilateral fund at the EBRD that is untied (i.e. procurements are not limited to Canadians).

Summary of EBRD Operations in 2006

2006 was an eventful year at the EBRD. Following the Annual Meeting, the Bank embarked on implementing the third Capital Resources Review (CRR3), a forward-looking, medium-term strategy that reflects a new focus in its operations. This new plan requires the Bank to revisit some of its existing policies and develop new ones to respond to challenges anticipated over the next five years.

The operational objectives of the CRR3 are to develop the portfolio with a base-case objective of €21.9 billion by 2010, and to achieve an annual business volume of around €3.6 billion. The geographical composition of the annual business volume is projected to shift in line with the strategic direction of the CRR3. The portfolio share of the early and intermediate transition countries and Russia is set to grow to around 87 per cent by 2010.

The CRR3 resource framework reflects both the increased workload driven by a rising portfolio in a more complex environment and a sustained focus on efficiency and internal resource reallocation. To support the CRR3 resource framework requirements, the EBRD administrative budget for 2006 was set at €226.6 million. The Bank's financial results contribute to a firm implementation of the strategic objectives set out in the CRR3.

In December 2006, the Executive Board approved the Bank's administrative budget of €267.7 million for 2007. This represents a real increase of 3.5 per cent, the first real increase since 1995.

Chart 2

Summary of the Financial Position of the EBRD in 2006

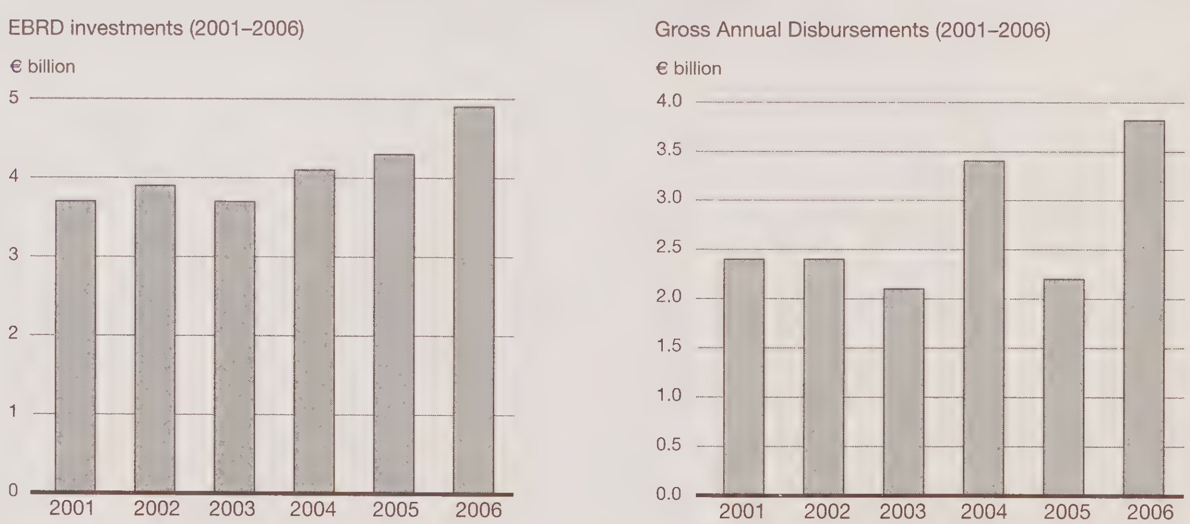
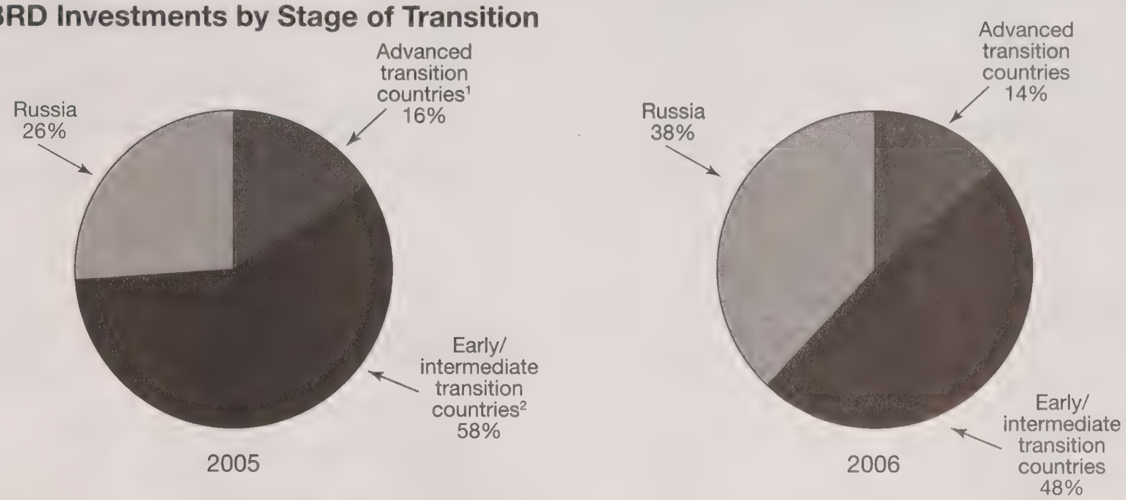


Chart 3

EBRD Investments by Stage of Transition

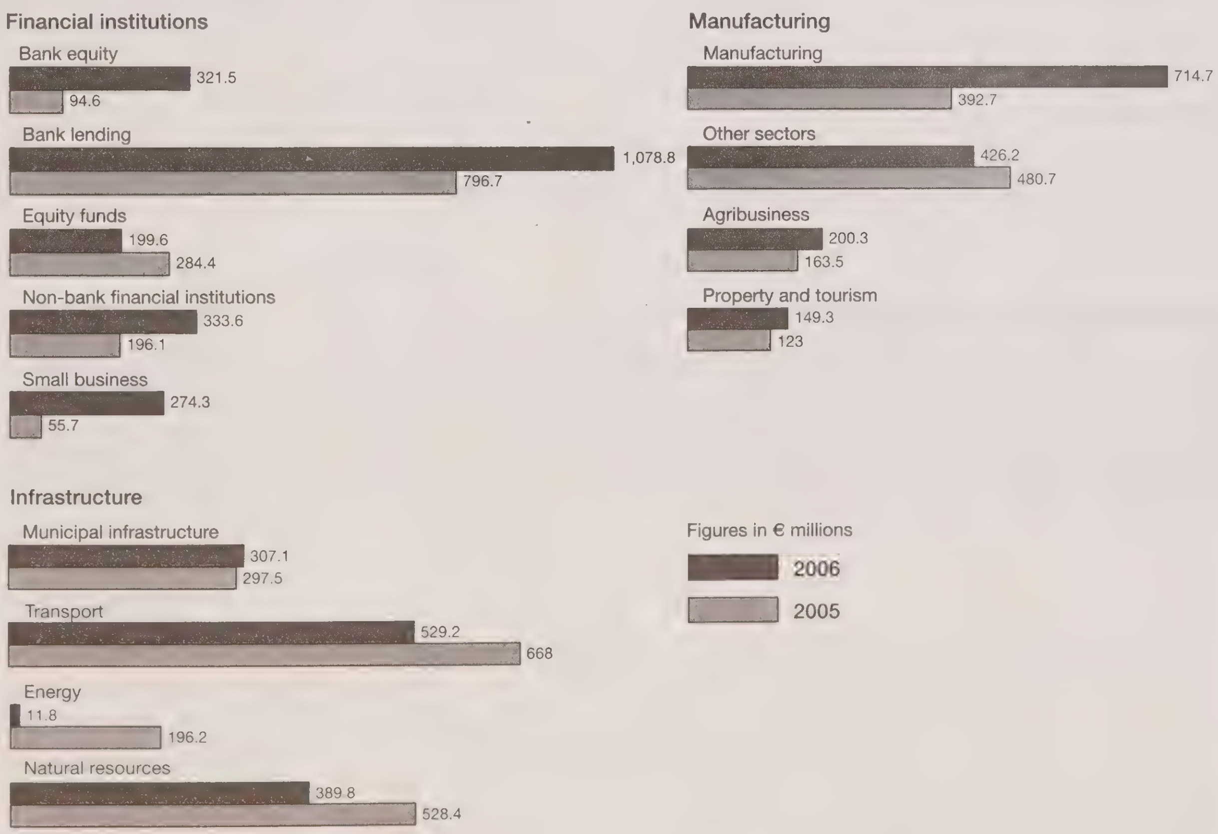


[1] Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic and Slovenia.

[2] Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Georgia, Kazakhstan, Kyrgyz Republic, FYR Macedonia, Moldova, Mongolia, Montenegro, Romania, Serbia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.

Chart 4

Summary of the EBRD's Investments in 2006



Annual Investments: 2003–2006

	2003	2004	2005	2006
Number of projects	119	129	151	157
EBRD financing (€ million)	3,721	4,133	4,277	4,936
Resources mobilized (€ million)	5,307	8,799	6,211	8,915
Total project value (€ million)	**9,028**	**12,932**	**10,499**	**13,851**

Note: Totals may not add due to rounding.

Financial Results: 2003–2006

	2003	2004	2005	2006
		(€ million)		
Operating income	538.1	658.6	1,543.9	2,667
Expenses and depreciation	(198.6)	(189.8)	(218.9)	(225)
Operating profit before provisions	339.5	468.8	1,325.0	2,442
Provision for impairment of loans and guarantees	(11.3)	(67.2)	200.6	(53)
Net profit for the year	**328.2**	**401.6**	**1,525.6**	**2,359**
Reserves and retained earnings	911.7	1,686.0	4,656.1	6,974
Provisions for impairment of loans and guarantees (cumulative)	505.4	539.5	351.6	1,341
Total reserves and provisions	**1,417.1**	**2,225.5**	**5,007.7**	**7,315**

Transition Impact

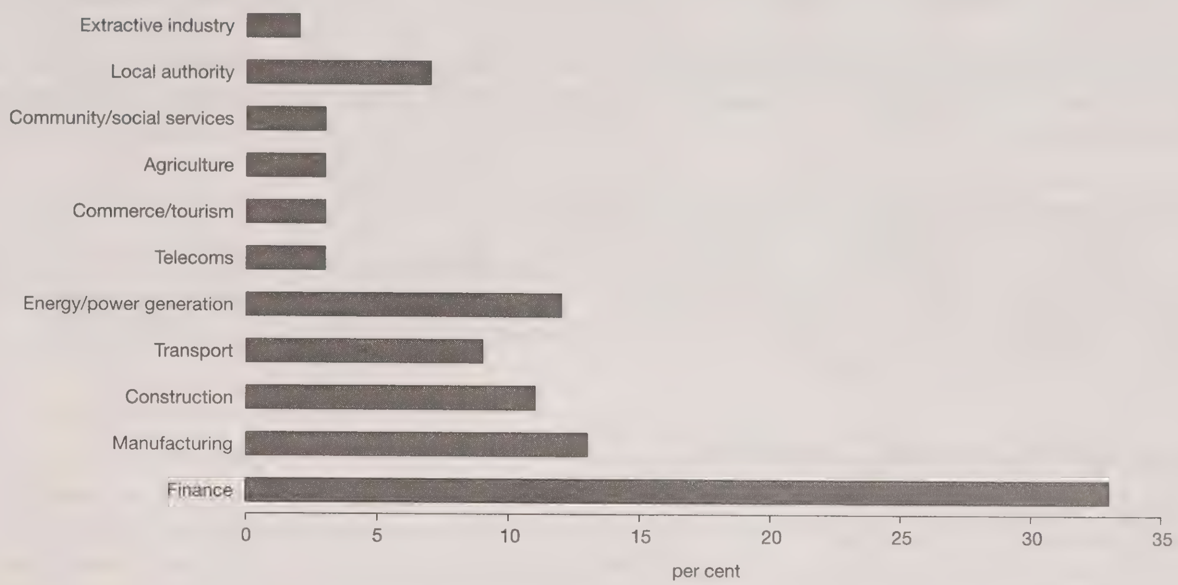
The share of new stand-alone signings with a transition impact potential rated "good" or "excellent" is currently estimated to be above the base-case objective of 75 per cent and close to the upper end of the range of 80 per cent.

Portfolio Development

The reported portfolio is currently estimated at approximately €17.7 billion, up 5 per cent from 2005. Driven by a high number of new commitments in 2006, the number of active portfolio operations increased by 5 per cent to 1,283 at the end of 2006, up from 1,225 at the end of 2005. Capital utilization at the end of 2006 is estimated to be close to the ratio projected for the end of 2006 in the CRR3 at around 80 per cent.

Chart 5

2006 Portfolio by Sector



Operational Highlights[6]

The EBRD invests in virtually every kind of enterprise and financial institution, mainly in the form of loans and equity. Investments are designed to advance the transition to market economies, to set the highest standards of corporate governance and to promote environmentally sound and sustainable development. The EBRD seeks to finance only those projects that will benefit from EBRD involvement and which cannot be funded on equivalent terms by the private sector.

Environmental Investments

The EBRD invested €346 million in energy efficiency, municipal infrastructure and cleanup operations in 2005, representing 8 per cent of the Bank's total investment for the year. This generated additional environmental investment of €552 million from the EBRD's clients.

The Bank provided a further €369 million for the environmental aspects of projects in other sectors, such as manufacturing, heavy industry and agribusiness. This generated additional environmental investment of €269 million from EBRD clients.

Consultation

The Bank consulted widely with governments, industry, non-governmental organizations (NGOs), research institutes and think tanks on its draft Energy Policy in 2006. The EBRD also liaised extensively with NGOs and local communities on projects with complex environmental considerations, such as a proposed EBRD investment on Sakhalin Island.

[6] As the Annual Report went to press, the 2006 figures were not available. The following paragraphs provide a snapshot of the 2005 investment. For updates on the 2006 amounts, refer to the 2006 Sustainability Report, which will be available in the summer at www.ebrd.com/pubs/general/series/sustain.htm.

Environmental and Social Monitoring

EBRD staff made environmental and social monitoring visits to 26 projects in 14 countries in 2005. Four of these visits focused specifically on social monitoring.

In 2005, the Bank appointed its first social development expert, whose role is to work with the Bank's clients to address potentially negative social impacts and to identify opportunities to increase community benefits.

Projects With Significant Social Benefits

The EBRD invested €254 million in 2005 to promote the growth of small businesses, which are vital for the creation of new jobs and for a country's long-term growth. EBRD financing is provided through over 1,000 local banks that on-lend to small businesses. In 2005, some 480,000 loans totalling US$3 billion were provided.

Helping the Poorest Countries

In 2005, the EBRD invested €250 million in 61 projects across the seven poorest countries where the Bank operates (the early transition countries). Investment was almost three times higher than in 2004. Supported by donor funding, the Bank's investment is helping to boost business growth and alleviate poverty.

Challenges Ahead

The experience of the past decade has shown that transition is a complex, demanding and lengthy process. A market economy has to be supported by an effective institutional framework and a functioning state. In the new regions of the EBRD's operations, there are basic weaknesses in key institutions, particularly concerning finance, regulation and competition, corporate governance, and the rule of law and its enforcement. The main transition challenges in the coming years lie in creating a reliable institutional and policy environment which attracts investment flows, encourages both the growth of the new private sector and the restructuring of the old, improves the functioning of markets, fosters entrepreneurial and market skills, and strengthens the confidence of the population in the reform process. The EBRD is well positioned to address these challenges and support its countries of operations in moving towards market-oriented economies. However, as the Bank faces these challenges, it will be crucial that it continue not only to draw on its proven strengths, but also to adjust, innovate and lead by example.

Key challenges for the Bank are as follows:

- As transition proceeds at different paces across the region, the Bank will need to be effective and efficient in its allocation of funds. In the next four years, the Bank will significantly decrease its activities in the advanced transition countries and shift its focus to the east and south, where its transition efforts will have the greatest impact. The Bank must develop new, specific products that best meet the needs of its new clients and ensure that its existing expertise and tools continuously adapt to new challenges.
- In order to operate effectively and efficiently in a more complex operating environment, the Bank must continue to evolve its business model—adapting its core banking activity to dynamic transition challenges and the more difficult business environments of the early and intermediate transition countries and Russia. More resources, including staff, will need to be concentrated in the early and intermediate transition countries.
- Expanded cooperation will also be necessary to develop high-transition-impact projects with explicit social and poverty alleviation benefits in order to strengthen the willingness of governments in some of the early transition countries to move forward with politically difficult but essential reforms, particularly the restructuring or closure of large state-owned enterprises.
- Good corporate governance for all recipient countries will continue to figure prominently in the period ahead, and the EBRD will need to promote sound institutions, more efficient tax collection and improved legal and regulatory frameworks. It must ensure not only that appropriate legislation is developed, but also that it is properly implemented and enforced.
- It remains both a priority and a challenge for the EBRD to encourage adherence to good governance in line with the Article 1 principles of multi-party democracy and pluralism. In countries of operations where the commitment to Article 1 principles remains weak, notably Belarus, Turkmenistan and Uzbekistan, the Bank should continue its narrow scope of operations.
- As the region overall experiences strong economic growth and a higher inflow of foreign capital investment, the Bank will need to focus that much more on identifying projects with significant transition potential.
- A key element underpinning the Bank's ability to influence transition is the demonstration effect of its own governance policies. The Bank must continuously review and update its internal policies in order to strengthen its governance standards to meet best corporate practice.

- Continued cooperation among international financial institutions (IFIs) is necessary to create a supportive environment that furthers transition. This involves, to the extent possible, an effective articulation between policy dialogue and projects; an emphasis on transition impact, development and additionality to ensure IFI assistance is effective; and the strong mobilization of private sector capital.

For More Information on the EBRD

The Bank releases considerable information on its various activities. Bank publications include information guides (such as *Financing With the EBRD*), special reports (such as the Annual Report and *Transition Report*), country strategies and assorted fact sheets. Information can also be obtained on the Bank's website at www.ebrd.com.

Requests for information can be addressed to:

Publications Desk
European Bank for Reconstruction and Development
One Exchange Square
London, EC2A 2JN
United Kingdom
(Fax: +44 20 7338 7544)

Annex 1—Summary of the *Transition Report*

The *Transition Report* is an annual publication of the EBRD that charts the progress of transition from a centrally planned to a market economy in each of the Bank's 29 countries of operations. The *Transition Report* is recognized as the leading publication analyzing the progress of transition in the former Soviet bloc. The 2006 report focused on the evolution of the financial sector in the transition countries. The report charts the financial development that has occurred and highlights the large variation across the transition countries in terms of how credit is provided to the private sector.

Macroeconomic Overview and Reform Progress

The EBRD reports that the transition region is gradually catching up with Western Europe and other mature market economies. It finds that transition is being driven increasingly by competitive markets rather than by governments, particularly in the financial sector and in the mobile phone market. It projects 2006 economic growth of 6.2 per cent, up from 5.7 per cent in 2005 and higher than in the eurozone.

The report explains that growth was partially due to high prices and demand for oil and gas, metals and agricultural commodities of the transition region's resource-rich countries, but that it was mainly driven by domestic consumption. These factors put pressure on inflation throughout the region, to which many central banks responded with anti-inflationary measures, such as raising interest rates and introducing stricter regulations on minimum reserves. Against this backdrop, the EBRD reports fiscal policy as being too loose to stem domestic demand more effectively and calls for a more restrictive approach given the long-term implications of aging populations, which will put significant pressure on public budgets.

With domestic savings insufficient to cover investments, the Bank reports large current account deficits, especially in countries not rich in natural resources. Foreign direct investment tapered off in 2006 and several countries' currencies came under pressure in foreign exchange markets, reflecting a more critical assessment by foreign investors of vulnerabilities in the region's emerging market economies. In addition, the Bank comments that higher interest rates in 2006 in the major OECD countries diminished the appetite for investment in transition countries.

In the context of these macroeconomic challenges, the Bank reports significant progress in reform. As shown in the following table, the Bank reports 24 transition score upgrades in 16 countries and no downgrades in 2006. The Bank tracks reform developments in 29 transition countries through a set of 9 transition indicators. These cover four main elements of a market economy—enterprises, markets and trade, financial institutions and infrastructure. Market liberalization—or initial-phase reform—was reported to be virtually complete in the advanced transition countries of Central Europe and the Baltic region and in much of Southeastern Europe, but there is still room for improvement in the Western Balkans, the Commonwealth of Independent States and Mongolia. Second-phase reform—dealing with building market-supporting institutions, such as large-scale privatization, governance and enterprise restructuring, competition policy, financial sector development and infrastructure—is far from complete.

Progress in Transition in EBRD Countries of Operations

			Enterprises			Markets and trade			Financial institutions		Infrastructure
Countries	Population (millions, mid-2006)	Private sector share of GDP in %, mid-2006 (EBRD estimate)	Large-scale privatization	Small-scale privatization	Governance and enterprise restructuring	Price liberalization	Trade and foreign exchange system	Competition policy	Banking reform and interest rate liberalization	Securities markets and non-bank financial institutions	Infrastructure reform
Albania	3.2	75	3	4	2+↑	4+	4+	2	3-	2-	2
Armenia	3.2	75	4-	4	2+	4+	4+	2+	3-	2	2+
Azerbaijan	8.3	60	2	4-	2	4	4	2	2+	2-	2
Belarus	9.8	25	1	2+	1	3-	2+	2	2-	2	1+
Bosnia and Herzegovina	3.8	55	3-	3	2	4	4-	2-↑↑	3-	2-	2+
Bulgaria	7.7	75	4	4↑	3-	4+	4+	3-	4-	3-↑	3
Croatia	4.4	60	3+	4+	3	4	4+	2+	4	3↑	3
Czech Republic	10.3	80	4	4+	3+	4+	4+	3	4	4-	3+
Estonia	1.3	80	4	4+	4-	4+	4+	4-↑	4	4-↑	3+
FYR Macedonia	2.0	65	3+	4	3-↑	4+	4+	2	3-	2+	2
Georgia	4.6	70↑	4-	4	2+	4+	4+	2	3-	2-	2+
Hungary	10.1	80	4	4+	4-	4+	4+	3+	4	4	4-
Kazakhstan	15.1	65	3	4	2	4	4-	2	3	3-↑	3-↑
Kyrgyz Republic	5.1	75	4-	4	2	4+	4+	2	2+	2	2-
Latvia	2.3	70	4-	4+	3	4+	4+	3	4-	3	3
Lithuania	3.4	75	4	4+	3	4+	4+	3+	4-	3	3↑
Moldova	3.4	65↑	3	4-	2	4	4+	2	3-	2	2+
Mongolia	2.7	70	3	4	2	4+	4+	2	2+	2	2
Montenegro	0.7	65	3+	3	2	4	3+	1	3-↑	2-	2-
Poland	38.1	75	3+	4+	4-	4+	4+	3	4-	4-	3+
Romania	21.7	70	4-	4-	3-↑	4+	4+	3-↑	3	2	3+
Russia	144.1	65	3	4	2+	4	3+	2+	3-↑	3↑	3-
Serbia	8.3	55	3-	4-↑	2+	4	3+	2-↑↑	3-	2	2
Slovak Republic	5.4	80	4	4+	4-	4+	4+	3+	4-	3↑	3-
Slovenia	2.0	65	3	4+	3	4	4+	3-	3+	3-	3
Tajikistan	6.5	55	2+	4	2-	4-	3+	2-	2+↑	1	1+
Turkmenistan	6.5	25	1	2	1	3-	1	1	1	1	1
Ukraine	47.1	65	3	4	2	4	4-	2+	3↑	2+	2+↑
Uzbekistan	26.0	45	3-	3+↑	2-	3-	2	2-	2-	2	2-

Note: The classification of transition indicators uses a scale from 1 to 4, where 1 implies little or no progress with reform and 4 implies a market economy. A rating of 4+ indicates the country has achieved standards and performance typical of advanced industrial economies. An arrow indicates change from the previous year. One arrow indicates a movement of one point (from 4 to 4+, for example) and two arrows a movement of two points.

Source: EBRD, *Transition Report 2006: Finance in Transition.*

Report Focus: "Finance in Transition"

The EBRD reports that financial markets in the transition countries have grown in scope and complexity in recent years, and the performance of banks is improving. Bank lending has increased, particularly from foreign-owned banks lending to households. Stock markets are becoming an important complement to the banking system and a private equity industry is emerging, though legal and regulatory barriers still need to be overcome. The EBRD finds that due to failings in the legal framework, financial markets are less developed than in other countries with comparable income. This suggests that financial systems must develop further before the full growth potential of these economies can be exploited.

As the general institutional framework has improved in transition countries, the EBRD has observed a strengthening of the link between increasing entry of foreign banks and the efficiency and stability of the banking systems, but notes that their presence should not be seen as a substitute for institutional reforms. It points to the lack of institutional reform in areas such as creditor rights and credit registries as the main factor holding back financial development. Moreover, it comments that dominance of a relatively small number of large multinational banking groups has introduced the possibility of economic downturns or financial crises being transmitted from one country to another.

The Bank notes that improving access to financial resources for enterprises and for new businesses is still a fundamental challenge for the transition countries. Despite rapid financial development, most firms in the region still rely on internally generated funds and contributions through informal channels that are in no way linked to the formal financial system. As the transition region develops, growth will increasingly need to stem from innovation, requiring riskier and longer-term investments from financial institutions. Widening financial access will require a variety of measures, such as improving the quality of supervision of the banking system, enforcing competition policy and encouraging the growth of other financial services.

More broadly, the Bank calls for investment in improving the business climate and maintaining skill levels, for example through development of higher education and improvements to social infrastructure, as a key requisite for sustaining strong growth performance in the region. The Bank's concern is that activities such as research and product development will be centralized in corporate headquarters in the world's financial capitals, leaving local institutions with less demanding tasks and a less dynamic local workforce, thereby threatening the sustainability of long-term growth.

Annex 2—CIDA Programming in EBRD Countries of Operations

In order to increase the effectiveness of its programming, the Canadian International Development Agency (CIDA) is focusing its efforts on 25 development partners. Of those, only one is in the EBRD's region of operations: Ukraine. Efforts in the region are therefore concentrated on this country. CIDA also has active bilateral programming in the Balkans (Bosnia and Herzegovina, Serbia, and Montenegro), South Caucasus (Armenia, Azerbaijan and Georgia), Tajikistan and Russia. The timeline for disengaging from of the Balkans is 2010. The highlights of CIDA's programming in EBRD countries of operations can be found below.

Ukraine—Since 1991, Canada has provided $309.5 million in development assistance to Ukraine. CIDA's Ukraine Program focuses on democratic governance, building institutional capacity and strengthening civil society to uphold democratic practices and principles, while at the same time supporting economic well-being through improving private sector development and the enabling environment for business. CIDA will increase its engagement in Ukraine, ramping up the program over the next few years in response to the momentum generated by a new pro-reform government in that country. The Country Programming Development Framework for Ukraine will be reviewed and updated in 2007 through a process involving public consultations.

Russia—As a Group of Eight (G8) member, a nuclear power, a key partner in the fight against terrorism and Canada's largest northern neighbour, Russia is of great strategic importance. To date, Canadian technical cooperation programming expenditures in Russia total over $315 million. Current CIDA programming in Russia is focused on delivering results related to governance and economic well-being. It covers four areas: increasing public sector competence, building an enabling environment for a market economy, building an engaged civil society, and supporting sustainable regional economic development in the Russian North. CIDA's Russia Program is preparing a new Programming Framework that will manage a smaller but strategically focused program that targets governance and civil society. CIDA will emphasize a whole-of-government approach to the Canada-Russia relationship.

Balkans—The international community's strong commitment to peace, stability and cooperation in the Balkans has started to show concrete results. A fragile peace has emerged and the political discourse is increasingly focused on the future and closely bound with the institutions and prosperity of Europe and EU accession. Since 1990, CIDA has disbursed over $540 million in funding in the Balkans for approximately 800 projects. The program is focusing its efforts in countries that are key to regional stability: Bosnia and Herzegovina, Serbia (including Kosovo) and Montenegro. CIDA's Balkans Program has shifted from post-conflict technical assistance to institutional capacity building, and is directed at initiatives that contribute to public sector reform and enhance social capital in the areas of rule of law, health and education. Gender, youth, environment and refugees are all cross-cutting issues. CIDA is planning to disengage from the Balkans by 2010.

South Caucasus—Programming in the South Caucasus has been modest—approximately $57 million since 1992. Georgia has been the main recipient, with Armenia and Azerbaijan benefiting through regional programming initiatives. The majority of resources have been allocated through responsive programming in the sector of governance (political and economic). CIDA's focus is on strengthening governance structures, building institutional capacity and enhancing respect for human rights. Gender and youth are cross-cutting issues.

Tajikistan—CIDA's main area of implication is agrarian reform in the sectors of governance and strengthening of private sector development. The initiatives support:

- The development of a comprehensive regulatory system and related procedures in support of the country's agrarian reform (e.g. debt resolution, farm restructuring and land rights).
- The resolution of excessive government centralization and lack of cooperation and understanding between local authorities and communities (e.g. partnership between local governments and civil groups to manage the communities' development).
- The capacity of the State Land Committees and community organizations to monitor land reform progress.
- The critical challenge of advancing women's access to land, and ensuring their participation in their communities' decision making.
- The reorganization of agricultural enterprises in a market economy, including the use of strengthened market information systems.
- The access of farmers to micro-credit and technical assistance.

Institutional Partnership Program (IPP)—The IPP works with selected multilateral and Canadian institutional partners that are addressing issues of regional and transboundary interests in the region. The IPP focuses on the EBRD and the Organization for Security and Co-operation in Europe, working with donors and recipient countries in the sectors of governance, private sector development and environment, with gender equality as a cross-cutting theme. The IPP helps coordinate and facilitate program activities undertaken by geographic programs and collaborates closely with government departments, particularly the Department of Finance and the Department of Foreign Affairs and International Trade, to ensure policy coherence and a whole-of-government approach to the availability of financing for the private sector.